

DEPARTMENT OF FOOD AND AGRICULTURE
Proposed Changes to Title 3, California Code of Regulations
To Adopt New Sections 2042, 2100, 2101, and 2102

INITIAL STATEMENT OF REASONS

Specific Purpose

These regulations will codify certain accounting procedures and principles that will be used to allocate payments and charges for bulk milk between dairy producers and handlers. The regulations will also set forth other procedures and definitions to clarify and explain how claims will be administered under the Milk Producers Security Trust Fund law.

The specific purpose of each section is as follows:

Section 2042 sets forth certain accounting procedures and principles that will be used to allocate payments and charges for bulk milk between dairy producers and handlers.

Section 2042 (a) states that payments made by handlers shall be applied first to bulk milk purchased from producers. It also states that exceptions are allowed in certain situations to provide flexibility to meet business needs. This will clarify to all handlers how the Department will allocate payments from handlers to producers. This allocation is consistent with the intent of Chapter 2.5 of the Food and Agricultural Code (FAC), which is that producers be paid promptly to ensure a stable supply of milk, which has been determined to be in the interest of the public's health and welfare.

Section 2042(a)(1) is an exception to 2042 (a), and provides that if a payment pattern of the handler is evident through documentation, then payments will be applied to be consistent with that pattern, rather than in accordance with 2042 (a). This will clarify to handlers that if they have an established pattern of making payments, that pattern will be respected and allowed as an exception.

Section 2042(a)(2) allows an exception to 2042 (a) when written documentation to allocate a payment to a specific charge is provided and sent along with the payment.

Section 2042(b) explains the payment sequence to be followed when allocating payments for past due obligations for bulk milk shipments.

Section 2100 defines beneficial ownership interest and how it is determined. This is necessary to provide clarification, because the FAC states that producers having a beneficial ownership interest in the handler to whom they ship their milk shall be ineligible for coverage from the Fund, but this term is not defined.

For Section 2100, the U. S. Code, Title 26, Section 318, Subtitle A, Chapter 1, Subchapter C, Part 1 of the Internal Revenue Code, which governs corporate distributions and adjustments, and constructive ownership of stock for income taxes, was used as a reference and guide. Since the

U. S. Code also deals with ownership issues and definitions, it was deemed to be applicable and appropriate for our purposes. The U. S. Code, Title 26, Section 318, and Section 1.414(c)-4 is also the reference and guide for these regulations for how beneficial ownership interest is defined for various types of business entities.

Ten percent or greater ownership interest in a company was used as the threshold of what constitutes beneficial ownership interest for the following reasons. The workshop group of dairy industry representatives who met to discuss concepts for these regulations suggested this amount as an ownership level that typically constitutes an ability to control business decisions. This amount was agreed to and accepted by all at the workshop. As a reference, the amount of 5 percent is used in Section 1.414(c)-4, Title 26, of the U. S. Code as an amount indicating ownership by a partner in an organization. It therefore seemed reasonable and supportable to use 10 percent.

Section 2100(b) specifies that persons and entities who have an ownership interest in the handler to whom they ship their milk are deemed to have a beneficial ownership interest, and therefore shall not be eligible for reimbursement from the Milk Producers Security Trust Fund (Fund).

Section 2100(c) specifies that authority to influence or create policy is not limited to service in an official capacity.

Section 2100(d) specifies that an individual must own a 10 percent or greater interest in the handler to have a beneficial ownership interest. Also, an individual who owns a 10 percent or greater interest as community property with her/his spouse is deemed to possess a beneficial ownership interest.

Section 2100(e) specifies that a producer who has extended credit to a handler does not have a beneficial ownership interest, unless that credit allows the producer to acquire a 10 percent or greater ownership interest in the handler in any form.

Section 2100(f) through (h) specifies when cooperatives are considered producers and when they are considered handlers, and further specifies when cooperatives and their members shall and shall not possess a beneficial ownership interest in a handler.

Section 2100(i) specifies beneficial ownership interest determinations for different types of corporations and their stockholders.

Section 2100(j) defines “Controlled Group of Corporations” (CGC) and specifies beneficial ownership interests of CGCs under various scenarios.

Section 2100(k) specifies what constitutes a beneficial ownership interest for partnerships, limited partnerships, joint ventures, estates, or trusts.

Section 2100(l) specifies what constitutes a beneficial ownership interest for limited liability companies.

Section 2101 specifies that when processed products are added to bulk milk, it changes the product such that it is no longer considered farm milk and is not therefore eligible for Trust Fund coverage.

Section 2102 clarifies and explains the steps in the process used to calculate payments to producers from the Trust Fund. It also emphasizes that only milk that meets the criteria stated in FAC Section 62580, defined as *eligible* milk, will be used in the calculations.

Necessity

Legislation enacted in 1987 created the Milk Producers Security Trust Fund (Trust Fund), a fund to pay producers in the event a handler fails to pay them for bulk milk purchases. The Legislature determined that it is in the interest of the health and welfare of the public to have a stable supply of milk, and that the marketing of milk requires that producers be paid promptly, and that they shall be protected against loss of payment for bulk milk. The law also states that only milk shipped by a producer to a handler, which meets certain criteria, shall be eligible for coverage. It was ten years before the first valid claims were filed and this law could be tested. Issues contained in these claims identified several areas of the FAC that needed regulations to clarify the procedures we will use in handling claims, and to define what is meant by “beneficial ownership interest”.

The need for Section 2042 became apparent when the department audited a claim to determine the amount owed to the producer. The defaulting handler had paid for milk purchased from another handler first, rather than paying for milk purchased from the producer, with the assumption that the producer would be reimbursed from the Trust Fund. It was obvious that to carry out the intent of this law, and to prevent unnecessary payments from the Trust Fund, all payments by handlers should be allocated first to producers, unless written documentation from the handler to the producer indicated that payments were for other specific charges.

Section 2042 is needed to explain and clarify the accounting formula for bond claims and Trust Fund claims, and the differences in how each are calculated. This section will ensure that all producers and handlers are aware that in the case of a payment default and a resulting claim against the Trust Fund, all payments will be applied first to bulk milk, unless documentation indicates otherwise. Standardizing the method of allocating payments in the event of a Trust Fund claim will ensure that producers will receive payments owed them, and the Trust Fund will not be unnecessarily used for reimbursement.

Section 2100 is needed for the following reasons. The FAC states if a handler defaults in paying a producer for bulk milk shipments, and that producer has a beneficial ownership interest in that handler, the producer’s milk is not eligible for coverage under the Trust Fund. However, the FAC does not define “beneficial ownership interest”. In the course of investigating a recent claim against the Trust Fund, it was discovered that a producer had an ownership interest in the handler who defaulted in payment. Although that claim was resolved, it was apparent that a regulation was needed to clarify what constituted “beneficial ownership interest” for future claims, so that all parties involved are aware and can properly assess risk and make informed business decisions.

Traditionally, dairy businesses have operated as proprietary firms. That has changed in recent years. They have consolidated alliances, and have experienced mergers, joint ventures, and acquisitions. They have reorganized themselves into much more complicated structures than when the law was originally written. The law now needs to be clarified through regulation to be more applicable to the needs of this changing industry.

Section 2100 defines “beneficial ownership interest” in a variety of situations: financial agreements, individuals, members of cooperative associations, cooperative associations, corporations, controlled corporations, stockholders, partnerships, joint ventures, estates and trusts, partners, and limited liability companies. This clarification will enable producers to be aware that certain ownership situations will cause them to be ineligible for coverage under the Trust Fund, and will assist them in making informed business decisions.

Section 2101 is needed to clarify the distinction between various products which are added to bulk milk, some of which alter the milk so that it is no longer eligible for all classes of usage and therefore no longer eligible for Trust Fund coverage. There are a variety of products, both processed and unprocessed, and dairy and non-dairy, which are added to milk at various stages of processing, and there has been some confusion as to which products change the milk sufficiently so that it is no longer bulk or farm milk and therefore no longer eligible for Trust Fund coverage.

Section 2102 is needed for the following reasons. The FAC states the eligibility requirements for milk to be covered by the Trust Fund (Section 62580), and it provides some direction on how the amounts owed to producers shall be calculated (Section 62623). However, the FAC does not specify the sequence of steps to be followed in the process used to calculate payments, nor does it state that only *eligible* milk shall be used as the basis for prorating the amounts due each producer. This regulation is needed to ensure the dairy industry clearly understands how the law will be applied in the event claims are filed by producers as a result of payment defaults from handlers. It is also needed to clarify and emphasize the intent of this law, which is to use the Trust Fund to pay producers for eligible milk only. If this clarification is not made, the Trust Fund could be charged for excess amounts, which would result in excess security charges to be assessed against the dairy industry to replenish the Fund, and may ultimately result in consumers being charged higher retail prices for milk.

Technical, Theoretical, and/or Empirical Study, Reports, or Documents

The following reference material was used in the preparation of the proposed regulations: “*The ABCs of LLCs*”, from Rural Cooperatives, July/August 1997 edition, published by the Rural Business and Cooperative Development Service of the University of Wisconsin Center for Cooperatives; and the U. S. Code, Title 26, Internal Revenue Code. Also, the Department held workshops for dairy industry representatives, and input was obtained which was used to prepare the regulations.

Summaries of the two workshops are included in the rulemaking package.

Reasonable Alternatives to the Regulation and the Reasons for Rejecting Those Alternatives

For Section 2042, an alternative is to not implement a regulation, and to follow the handler's wishes in allocating payments. This was discussed at dairy industry workshops and with the members of the Milk Producers Security Trust Fund Board (Board). The Board and other industry representatives rejected this option, because it would not be consistent with the intent of the law, which is to pay producers first in order to maintain their financial stability and ensure a supply of milk for consumers. It was the opinion of the dairy industry that this regulation would ensure the intent of the law is carried out, and would also be fair to all parties.

For Section 2100, less than ten percent ownership of a firm as the threshold for beneficial ownership interest was considered, but dairy industry representatives supported using ten percent as an appropriate and reasonable level.

For Section 2101, an alternative considered by the Board was to define eligible milk to include bulk milk products that has additional ingredients so long as they are dairy products or dairy byproducts. However, the Trust Fund exists to protect dairy farmers against defaults for the farm milk delivered to a dairy processor. Any subsequent processing other than "tailoring" or standardizing milk to meet the milk component requirements of the four fluid milk products defined in Section 62521 of the Code would make the product ineligible for coverage as farm milk under the MPSTF.

For Section 2102, dairy industry representatives and the Board rejected the alternative to apply the \$200,000 deductible to the total owed for all (eligible and ineligible) bulk milk shipments. They concurred that the intent of the law is to apply the deductible amount only to the bulk milk shipments meeting eligibility requirements.

Reasonable Alternatives Identified That Would Lessen Any Adverse Impact On Small Business

The Department has not identified any alternatives, nor have any alternatives been identified and brought to the attention of the Department that would lessen any adverse impact on small business.

Evidence Supporting Initial Determination of No Significant Adverse Economic Impact on Business

In Section 2042, the requirement that handler payments be applied first to producers will have a beneficial impact on the producer, by ensuring that they are paid for bulk milk shipments. The proposed regulation should have no adverse impact on the handler, since the handler is obligated to pay for all expenses incurred in the course of doing business.

In Section 2100, the proposed regulation should not have any economic impact on business, as it merely defines beneficial ownership interest.

In Section 2101, the proposed regulation should not have any economic impact on business, as it defines which ingredients may be added to bulk milk and allow it to remain eligible for Trust Fund coverage.

In Section 2102, the proposed regulation would have a neutral or positive economic impact on business, as it would prevent excess amounts from being paid by the Trust Fund, thereby reducing the need to implement security charges assessed on milk processors to replenish the Trust Fund.